

STATE OF CALIFORNIA
DEPARTMENT OF CORPORATIONS

CAPITAL AND REPORTING REQUIREMENTS

If the applicant for the investment adviser certificate has power of attorney to execute client transactions or has regular or periodic custody of the clients' securities or funds, including fees for periodic publications or other investment advisory services paid six months or more in advance of the services and *the applicant's principal place of business is in California*, the applicant is subject to the capital requirements as prescribed in §260.237.1 of the California Code of Regulations and the reporting requirements as prescribed in §260.241.2.

For your information, we have included material concerning California's capital and reporting requirements. Attached you will find the following:

- ◆ §260.237.1 (capital requirements) and excerpts from §260.241.2 (reporting requirements) and §260.237(e) (accountant's verification).
- ◆ Definition of the components used in the capital computations, formulas used in the capital computations, and the limitations.
- ◆ Worksheet that may be used as a guideline to calculate the capital requirements.
- ◆ Verification form.

We would also like to remind you that:

- ◆ At no time shall the investment adviser (a) permit its tangible net capital to be less than required, (b) permit its total aggregate indebtedness to exceed 500% of its tangible net capital or (c) permit its current aggregate indebtedness to exceed its current net capital.
- ◆ The annual report should be filed within 60 days after the end of the investment adviser's fiscal year. The annual report must include supporting schedules that contain the computations net capitals and aggregate indebtedness pursuant to §260.237.1. Annual reports prepared on a consolidated basis are not acceptable unless the investment adviser guarantees, endorses or assumes, directly or indirectly, the obligations or liabilities of its subsidiaries or affiliates.
- ◆ Any investment adviser who is subject to the minimum capital requirements must, in addition to the records otherwise required under §260.241.3, maintain a record of the proof of money balances of all ledger accounts in the form of trial balances and a record of the computations of net capitals and aggregate indebtedness pursuant to §260.237.1. The trial balances and computations should be prepared monthly by the tenth of each month.

We encourage you to carefully review the enclosed material, and if you have any questions, please feel free to contact this Department.

§ 260.237.1 Capital Requirements

(a) No investment adviser who has any power of attorney from any investment advisory client to execute transactions or has regular or periodic custody of any of its investment advisory clients' securities or funds, including fees for periodic publications or other investment advisory services paid six months or more in advance of the services, shall permit its total aggregate indebtedness to exceed 500% of its tangible net capital or permit its current aggregate indebtedness to exceed its current net capital and,

(1) The investment adviser shall at all times have and maintain tangible net capital of not less than \$25,000.00; or,

(2) If the investment adviser has any power or attorney from any investment advisory client to execute transactions and does not have regular or periodic custody or possession of any of its investment advisory clients' securities or funds, except the receipt of prepaid subscriptions for periodic publications, or other investment advisory services, it shall at all times have and maintain tangible net capital of not less than \$5,000.00; or,

(3) If the investment adviser receives fees for periodic publications or other investment advisory services paid six months or more in advance of the services and it does not have the authority described in subsection (a)(2) of this section or does not otherwise have regular or periodic custody or possession of any of its investment advisory clients' securities or funds, it shall at all times have and maintain tangible net capital of not less than \$1,000.00.

(b) Exemptions.

(1) The provisions of subsection (a) of this section shall not apply to any investment adviser licensed as a broker-dealer under Section 25210 of the Code and subject to the capital requirements of Section 260.216.12 of these rules.

(2) The Commissioner may, upon written application, exempt from the provisions of this section, either unconditionally or on specified terms and conditions, any investment adviser who satisfies the Commissioner that, because of the special nature of the investment adviser's business, its financial position, and the safeguards it has established for the protection of clients' funds and securities, it is not necessary in the public interest or for the protection of investors to subject the particular investment adviser to the provisions of this section.

(c) Definitions. For the purposes of subsection (a) of this section, all financial information shall be determined in accordance with generally accepted accounting principles; and,

(1) The term "tangible net capital" shall mean the net worth of the investment adviser, after excluding (A) intangible assets and (B) indebtedness which is subordinated to the claims of creditors pursuant to a satisfactory subordination agreement as hereinafter defined;

(2) The term "total aggregate indebtedness" shall mean the total money liabilities of the investment adviser including all unearned income and other deferred credits and excluding indebtedness which is subordinated to the claims of creditors pursuant to a satisfactory subordination agreement, as hereinafter defined;

(3) The term "current net capital" shall mean the current assets of the investment adviser and (A) includes all unpledged, readily marketable securities and (B) excludes all advances, loans or other receivables from any subsidiary, holding company, parent, or other affiliate or the officers, directors or controlling persons of such entities or the investment adviser;

(4) The term "current aggregate indebtedness" shall mean the sum of (A) 20% of the deferred or unearned income from receipts or revenues received on subscriptions for future periods and (B) the total of all other current liabilities;

(5) The term "satisfactory subordination agreement" shall mean a written agreement duly executed by the investment adviser and the lender which effectively subordinates any right of the lender to demand or receive payment or return of the cash or securities loaned to the claims of all present and future creditors of the investment adviser. The agreement shall provide that the cash or securities are loaned for a term of not less than one year and shall be in the form approved by the Commissioner.

(d) The computation of "total aggregate indebtedness," "tangible net capital," "current net capital," and "current aggregate indebtedness" shall include the consolidation of assets and liabilities of any subsidiary or affiliate for which it guarantees, endorses or assumes, directly or indirectly, the obligations or liabilities. The assets and liabilities of any subsidiary or affiliate whose liabilities and obligations have not been guaranteed, endorsed, or assumed, directly or indirectly, by the investment adviser shall not be so consolidated and the investment shall be valued at the underlying tangible value of the equity in such subsidiary or affiliate.

§260.241.2 Reports by Investment Advisers (in part)

(a) General Rule. Every licensed investment adviser subject to the provisions of Section 260.237.1 of these rules, shall file an annual financial report containing the information required by a form or forms to be supplied or approved by the Commissioner, as follows:

(2) The annual report for investment advisers shall contain a Statement of Financial Condition. Supporting schedules shall contain computations of net capitals, aggregate indebtedness and ratios required under Section 260.237.1 and the certificate of the accountant required under subsection (e) of Section 260.237 of these rules.

(3) The financial statements included in the annual report shall be prepared in accordance with generally accepted accounting principles and shall be audited by either an independent certified public accountant or independent public accountant; provided, however, the financial statements need not be audited if the investment adviser has not held or accepted custody of funds and securities for or owed money or securities to customer or clients during the period covered by the report and the investment adviser has taken only limited powers of attorney to execute transactions on behalf of its clients or otherwise permitted by the Commissioner.

(4) The reports shall be filed as of a date within each calendar year, but as of the same date in each year except that the first report shall be as of a date not more than 12 months after the date the licensee's certificate first becomes effective and except that the date may be changed with the approval of the Commissioner upon any change in the fiscal year of the licensee.

(5) The reports shall be filed not more than 60 days after the date as of which the reports purport to reflect the financial condition and results of operations of the investment adviser.

(6) Whenever the Commissioner so requires, a financial report shall be filed as of the date, and within the period, and in the form specified in the Commissioner's request. The Commissioner may require the financial report to be audited.

(b) Verification of Reports. Attached to each financial report filed pursuant to subsection (a) of this section shall be a verification that, to the best knowledge and belief of the person making the verification,

(1) The financial statements and supporting schedules are true and correct, and

(2) If the investment adviser is a sole proprietorship, the verification shall be made by the proprietor; if a partnership, by a general partner; or if a corporation, by a duly authorized officer.

(d) Interim Reports.

(2) Every investment adviser subject to the provisions of Section 260.237.1 of these rules shall file a report furnished or approved by the Commissioner within 15 days after (A) its tangible net capital is reduced to less than 120% of its required minimum tangible net capital or (B) its total aggregate indebtedness in excess of 400% of its tangible net capital.

(3) The report required by subsection (d)(2) of this section shall be as of a date within the 15-day period. Additional reports shall be filed on the same form within 10 days after each subsequent monthly accounting period until three successive months have elapsed during which none of the conditions specified in subsection (d)(2) of this section have occurred.

§ 260.237 Custody or Possession of Funds or Securities of Clients (in part)

It shall constitute a fraudulent, deceptive or manipulative act, practice or course of business, within the meaning of Section 25235 of the Code, for any investment adviser who has custody or possession of any funds or securities, except prepaid fees for periodic publications or other advisory services, in which any client has any beneficial interest to do any act or take any action, directly or indirectly, with respect to any such funds or securities unless:

(e) all funds and securities of clients are verified by actual examination at least once during each calendar year by an independent certified public accountant or public accountant at a time which shall be chosen by the accountant without prior notice to the investment adviser. A certificate of the accountant stating that such person has made an examination of the funds and securities, and describing the nature and extent of the examination, shall be filed with the Commissioner promptly after each examination.

§ 260.237.1 Ratios

Definitions:

1. Tangible Net Capital = New worth less unamortized intangible assets (i.e. deferred expenses, goodwill, organizational costs) plus subordinated debt pursuant to a satisfactory subordination agreement approved by the Commissioner of Corporations.
2. Current Net Capital = Current assets including unpledged, readily marketable securities less all related party receivables (i.e. advances, loans or other receivables from any subsidiary, holding company, parent, or other affiliate or the officers, directors or controlling persons of such entities or the investment adviser.)
3. Current Aggregate
Indebtedness = 20% of unearned fees from subscriptions and 100% of unearned fees from other advisory services plus the total of all other current liabilities.
4. Total Aggregate
Indebtedness = Total liabilities including all unearned income and other deferred credits less subordinated indebtedness approved by the Commissioner of Corporations.

Calculation of Ratios:

- | | | |
|----|----------------------------------------------------------------------------|---------------|
| A. | $\frac{\text{Current Net Capital}}{\text{Current Aggregate Indebtedness}}$ | $\frac{2}{3}$ |
| B. | $\frac{\text{Total Aggregate Indebtedness}}{\text{Tangible Net Capital}}$ | $\frac{4}{1}$ |

Limitations:

- A. Total Current Aggregate Indebtedness shall not exceed total Current Net Capital.
 - B. Total Aggregate Indebtedness (TAI) shall not exceed 500% of Tangible Net Capital (TNC).
- Note: Monthly reports are required if TAI is 400% or more of TNC or if TNC is less than 120% of the required minimum TNC.

TO THE COMMISSIONER OF CORPORATIONS OF
THE STATE OF CALIFORNIA

VERIFICATION FORM PURSUANT TO
RULES 260.241.2(b)

(Executed *WITHIN* or *WITHOUT* of the State of California)

I, _____, declare under penalty of perjury under the laws of the State of California that I have read the annexed financial report and supporting schedules and know the contents thereof to be true and correct to my best knowledge and belief; and neither the licensee nor any partner, officer, or director thereof have any proprietary interest in any account classified solely as that of a customer.

Executed this _____ day of _____ at

City State

(Signature of person signing report)

(Title of person signing report)

(Name of Licensee)

(File Number)

INSTRUCTIONS:

If the broker-dealer, investment adviser is a sole proprietorship, the verification shall be made by the proprietor; if a partnership, by a general partner; or if a corporation, by a duly authorized officer.